Supreme Court, U.S.
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NO. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1994

CAPITOL INDEMNITY CORPORATION

Petitioner,

v.

UNITED STATES OF AMERICA

Respondent.

Petition for a Writ of Certiorari
to the United States Court of
Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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April 21, 1995

QUESTIONS PRESENTED FOR REVIEW

Is a surety's right of equitable subrogation under Pearlman vs. Reliance Insurance Company, 371 U.S. 132, 136-137 (1962) a "security interest" subject to filing requirements under Article 9 of the Uniform Commercial Code and 26 U.S.C. §6323(c)?

PARTIES TO PROCEEDINGS

The parties to Case No. 93-3633 in the United States Court of Appeals for the Seventh Circuit were Capitol Indemnity Corporation, Mount Vernon (Illinois) Township High School District 201 and the United States of America. The parties before this court are the same as the parties below.

Capitol Indemnity Corporation is a wholly owned subsidiary of Capitol Transamerica Corporation. Capitol Transamerica Corporation is publicly traded and has no other subsidiaries, parent companies, affiliates, or shareholders which are required to be listed pursuant to Rule 29.1.

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PETITION FOR A WRIT OF CERTIORARI

Capitol Indemnity Corporation respectfully petitions for a writ of certiorari to review the judgment and order of the United States Court of Appeals for the Seventh Circuit entered

on November 30, 1994 and its Order of January 23, 1995, denying a rehearing.

OPINIONS BELOW

The November 30, 1994 order of the Seventh Circuit is reported at 41 F.3d 320 (7th Cir. 1994) and is reprinted in the Appendix ("App") at p. 1a. The Seventh Circuit denied a rehearing on January 23, 1995.

JURISDICTION

The United States Court of Appeals for the Seventh Circuit issued its opinion on November 30, 1994 and denied rehearing on January 23, 1995. This Court has jurisdiction to review the judgment of the United States Court of Appeals pursuant to 28 U.S.C. §1254(1). The Seventh Circuit's decision is in conflict

with Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); In re J. V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); and Home Indemnity Co. v. United States, 433 F.2d 764, 765 (Ct. Claims 1970). The District Court had jurisdiction under 26 U.S.C. §7426 and 28 U.S.C. §1346(e). The Seventh Circuit had jurisdiction pursuant to 28 U.S.C. §1291.

STATUTORY PROVISIONS INVOLVED

26 U.S.C. §6323(c), 810 ILCS §5/9-102(2) and 810 ILCS §5/9-302 are lengthy and are set forth in the appendix.

STATEMENT OF THE CASE

Petitioner is a surety company which bonded a public works project for Mt. Vernon (Illinois) Township High School

District 201. The bonded principal, B & H Construction Company ("Contractor") failed to pay subcontractors and materialmen and to complete the project. The School District then called upon Capitol to pay the subcontractors and complete the project under its bond; Capitol did so.

B & H also failed to pay withholding taxes due on payroll unrelated to the Mt. Vernon project. The United States filed a tax lien on Mt. Vernon School District. Capitol then filed this action to protect its rights in the contract funds. Both the IRS and Capitol filed cross motions for summary judgment. On August 23, 1993, the trial court ruled against the United States and in favor of Capitol. The Seventh Circuit reversed the trial court on various grounds including a

holding that Capitol was required to file a UCC Financing Statement to protect its equitable rights of subrogation and therefore could not prevail against the Internal Revenue Service under 26 U.S.C. §6323(c).

REASONS FOR GRANTING THE WRIT

The Court should grant the petition to clarify the rights of a contract bond surety under 26 U.S.C. §6323(c) and Article 9 of the Uniform Commercial Code in order to promote uniformity and predictability of the rights of various parties to contract funds for construction projects throughout the United States. The Seventh Circuit decision is in direct conflict with Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843, (1st Cir.

1969); In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); and Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970) which was decided in view of the Uniform Commercial Code as adapted in Illinois.

26 U.S.C. §6323(c) gives a surety a "superpriority" over the IRS lien if it could prevail over a judgment lienholder under state law.

As a contract bond surety, Capitol has the right of equitable subrogation:

> "... a surety who pays the debt of another is entitled to all of the rights of the person he has paid to enforce his rights to be reimbursed". Pearlman vs. Reliance Insurance Company, 371 U.S. 132, 136-137 (1962).

Such subrogation rights have long been recognized by the Court.

Pearlman v. Reliance Insurance Company, 371 U.S. 132, 136-137 (1962); Henningsen v. United States Fidelity and Guaranty Co., 208 U.S. 404 (1905); Prairie State National Bank v. United States, 164 U.S. 227 (1956).

Such subrogation rights are extra contractual. The distinction between a surety's rights under (1) subrogation; and (2) a contract (i.e. a General Indemnity Agreement) is critical to any UCC analysis. As two prominent UCC commentators have noted:

> "Article Nine applies only to consensual security interests. The surety's subrogation claim is not consensual, but is based on the **'status *** inhering in a surety.** Accordingly, conflicts between the rights of the surety and third parties must be resolved

> outside Article Nine." White and Summers, Uniform Commercial Code, 3rd ed. at 948.

To Petitioner's knowledge, no American court in thirty years has held that a surety's subrogation[1] rights are subject to UCC filing requirements. The drafters of the Uniform Commercial Code expressly rejected any efforts to require a surety to perfect its subrogation rights to contract funds by filing under Article 9. See **Uniform Laws Annotated, Uniform Commercial Code, Official Draft, Text and Comments**, at 773, 777 (1952);

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[1] The Sixth Circuit ruled against a surety in a case that dealt with a surety's contractual rights under an indemnity agreement as opposed to the extracontractual subrogation rights of a surety. In re Construction Alternatives 2 F.3d 670 (6th Cir. 1993). As noted above, there is a clear distinction between consensual security interests and a surety's subrogation rights.

Uniform Laws Annotated, Uniform Commercial Code, Changes in text and Comments, at 25-26 (1953). quoted in Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); T. Scott Leo, Construction Contract Surety and Some Suretyship Defenses, 34 Wm. & Mary L. Rev. 1225, 1234 n. 31 (1983).

As Judge Robert Brauchner (one of the drafters of Article 9) has explained -- a surety's equitable right is not a security interest and therefore is not subject to the perfection requirements of Article 9. Instead, it is one of those equitable rights which survived the enactment of the UCC because the UCC did not even purport to affect it. Canter v. Schlager, 358 Mass. 789, 267 N.E.2d 492, 494.

The First Circuit cogently outlined the history behind the exemption of a surety from the filing requirements of Article 9:

> "The Surety Companies' representatives convincingly took the position that subsection (7) as it stands is a complete reversal of the case law not only of the Supreme Court of the United States but also of the highest courts of most of the states. They cited Prairie State National Bank v. United States, 164 U.S. 227, 17 S.Ct. 412 (1896) ; United States v. Munsey Trust, 332, U.S. 404, 28 S.Ct. 1599, 91 L.Ed. 2022 (1947) at 240; 9 Am.Jur. 72 §§ 114, 115, 43 Am. Jur. 939, 197 et seq.; 60 C.J. Subrogation § 87; Stearns Law of Suretyship, 5th Ed. (1951), Page 472; Appeal of Lancaster County Natl. Bk., 304

Pa. 437, 155 A. 859 (1931); and 127 A.L.R. 974, 976.

"Under the cited case law, the surety's rights come first as to the funds owing by the owner unless the surety has subordinated its right to the bank. Subsection (7) of the Code as written would reverse the situation and give the bank priority in all cases.

"Under existing case law, both the contractor and the bank are in a position to bargain with the surety which may or may not be willing to subordinate its claim. Under subsection (7) as written in the Code the surety company would have nothing to bargain about." Uniform Laws Annotated, Uniform Commercial Code, Official Draft, Text and Comments , at 773, 777 (1952);

> Uniform Laws Annotated, Uniform Commercial Code , Changes in Text and Comments, at 25-26 (1953). quoted in Shawmut National Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st. Cir. 1969)

The Eighth Circuit and the Court of Claims both concur with the Shawmut National Bank result and reasoning. In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970).

These holdings are in accord with virtually all courts examining the issue. **Alabama** First Ala. Bank., etc. v. Hartford Acc. & I. Co., 430 F.Supp. 907 (N.D. Ala. 1977); **Alaska** Alaska State Bank v. Gen Ins. Co., 579 P.2d 1362 (Alaska 1978); **Florida** McAtee v. United States Fidelity & Guaranty Ins. Co., 401

F.Supp. 11 (N.D.Fla. 1075); Transamerica Ins. Co. v. Barnett Bank, 540 So.2d 113, 117 (Fla. 1989); **Georgia** Argonaut Ins. Co. v. C & S Bank of Tifton, 140 Ga.App. 807, 232 S.E.2d 135 (Ga.App 1976); **Illinois** Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970); **Iowa** First Fed. State Bank v. Town of Malvern, 270 N.W.2d 818 (Iowa 1978); **Kansas** United States F&G Co. v. First State Bank of Salina, 208 Kan. 738, 494 P.2d 1149 (Kan. 1972); **Kentucky** National Sur. Corp. v. State Nat. Bank of Frankfort, 454 S.W.2d 354 (Ky.App. 1970); **Maryland** Finance Co. of America v. U.S. Fid & Guar. Co., 277 Md. 177, 353 A.2d 249 (Md. App. 1976); **Massachusetts** Canter v. Schlager, 267 N.E.2d 492 (Mass. 1971); **Michigan** American Oil Co. v. L.A. Davidson, Inc., 290 N.W.2d 144 (Mich.

App. 1980); **Minnesota** In Re J.V. Gleason Co., 452 F.2d 1219 (8th cir. 1971); **Missouri** First State Bank v. Reorganized Sch. Dist. R-3, Bunker, 495 S.W.2d 471 (Mo.App. 1973); **Oklahoma** Mid-Continent Cas. Co. v. First National Bank & Trust Co., 531 P.2d 1370 (Okla. 1075); **Pennsylvania** Jacobs v. Northeastern Corp., 416 Pa. 417, 206 A.2d 49 (Pa.App. 1965); **Texas** Interfirst Bank Dallas v. United Fidelity and Guaranty Company, 774 S.W.2d 391, 398 (Tex.App. 1989); **Vermont** First Vermont Bank & Trust Co. v. Village of Poultney, 349 A.2d 722 (Ver. 1985); and **Wisconsin** Matter of Don's Elec. Inc., 65 B.R. 399 (Bkrtcy. W.D. Wis. 1986).

Accordingly, the Petitioner submits that it is not required to file a UCC Financing Statement in order to protect

its rights under 26 U.S.C. §6323(c) because the UCC Article 9 does not govern its extra contractual rights.

Notwithstanding such well established case law, however, the Seventh Circuit failed to recognize such a distinction in its analysis:

> "... the surety's claim was not perfected, thus not protected under local law against a judgment lien," See 810 ILCS 5/9-302 (Illinois law requires sureties to file financing statement in appropriate office in order to perfect claim." Opinion at 12.

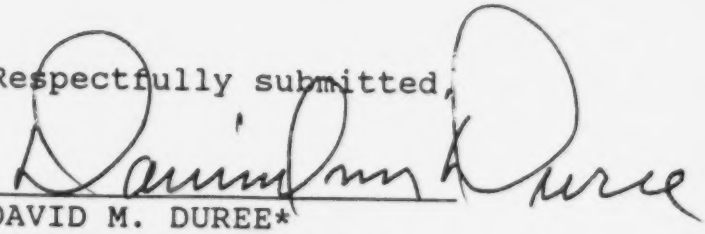
The court has not cited any case nor has Petitioner has found any American case in the last thirty years that has construed Article 9 of the UCC to preempt a surety's rights of equitable right of subrogation under the Pearlman doctrine. Such opinion conflicts with the First Circuit opinion in Shawmut National Bank

v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969); the Eighth Circuit opinion in In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); and the Court of Claims decision in Home Indemnity Co. v. United States, 433 F.2d 764 (Ct. Claims 1970). It has also taken the "uniformity" out of Article 9 of the Uniform Commercial Code as to a surety's right of equitable subrogation.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,



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